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Observations

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FEDERAL BUDGET

The President's Midsession Review

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This statement discusses the President's Midsession Review and the implications of the President's proposals on fiscal policy and the federal budget. The press has focused on the fact that both OMB and CBO have revised upward their projections for the unified budget surplus. The phrase "$1 trillion more" has been widely reported in the media. Further, these new projections show an on-budget surplus throughout the next 10-15 years.

An earlier-than-expected and larger-than-expected surplus is only good news for the future health of our economy—if two conditions are met. First, the surplus must be realized. Second, the surplus must be put to prudent use. To the extent that the surplus is used for debt reduction, it offers the benefit of lower interest costs. And the miracle of compound interest means that savings in today's interest payments will yield benefits tomorrow.

The surplus we celebrate today came about not only through stronger-than-expected economic growth but also as the result of some difficult policy choices you and the President made over the past years. Now, after the recent years of tight discipline and focus on fiscal responsibility, the surplus offers a chance to debate the relative merits of different priorities. Should some of the surplus be used to meet pent-up demand for spending in certain domestic discretionary areas? For an increase in defense spending? For tax cuts? To secure existing unfunded entitlement promises? For debt reduction? For a combination of all of these? Most would not argue for devoting 100 percent of the surplus to debt reduction over the next 10 years. However, unless a good portion of the surplus is saved, it will not be used to redeem debt, and we will lose a portion of the interest savings. And it is critical to save a good deal of the surplus because known demographic trends require that we hand the next generation a stronger economy and a lower debt burden.

A Federal Reserve Board chairman once described his job as to "take away the punch bowl when the party was just getting going." My job as Comptroller General of the United States, I believe, is to serve as an accountability cop at the surplus celebration party and to offer a note of caution about how we deal with this welcome shift from an environment of persistent deficits to one of projected large surpluses.

There are several reasons to be prudent:

1. These large on-budget surpluses are still projections, and the history of budget projections—especially over a long period—should give us pause about making large and long-lasting commitments that consume the surplus. Even in the near term these projections are optimistic and may not be realized since, among other things, they assume full compliance with existing tight caps on discretionary spending. Further, the fact that even given these assumptions a little over half of the surplus occurs 11-15 years from now should make us even more cautious about committing these surpluses for permanent changes on either the revenue or the spending side.

2. We enter this surplus period with a large debt built up from years of running deficits. Deficits are an indication that the American people are getting more government benefits and services than they are paying for. Just as families that have built up debt during years in which expenses exceeded income use newfound income to reduce that debt, so the federal government might think about using surplus to reduce its debt. This is especially important given known demographic trends whereby fewer and fewer workers will be supporting a growing retired population for longer periods of time.

3. In addition—and this makes the previous point even more salient—we face looming cost pressures over the next decades which will lead to a significant decline in budgetary flexibility unless current policies are changed. Absent any changes in Social Security, Medicare, and Medicaid, the budget will increasingly be absorbed by payments to the retired—making it more difficult to meet other priorities. In addition, Social Security and Medicare are not the only cost pressures on the horizon. Bills will also come due for a variety of other commitments and contingencies such as cleanup costs from federal operations known to result in hazardous waste, including defense facilities and weapon systems, and federal insurance programs.

The following discusses each of these in turn and then moves on to discuss briefly the President's proposals.

Projections Are Uncertain

The history of budget forecasts should remind us not to be complacent about the certainty of these large projected surpluses and make us cautious about committing them to large permanent tax cuts or spending increases. In a recent outlook book, CBO compared the actual deficits or surpluses for 1988 through 1998 with the first projection it had produced 5 years before the start of each fiscal year. Excluding the estimated impact of legislation, CBO says its errors averaged about 13 percent of actual outlays. Such a shift in 2004, for example, would mean a potential swing of about $250 billion in the surplus.

It is important to remember that it was not so long ago that forecasts were for "deficits as far as the eye can see." Today we are pleasantly surprised by upward revisions in surplus estimates. Yet only a decade ago we were being unpleasantly surprised by upward revisions in deficit estimates. I note this not to raise questions about either OMB or CBO analysis but rather to remind us all about the inherent uncertainty of projections.

All projections are heavily dependent on assumptions that, while reasonable, may still not hold. And in a budget of nearly two trillion dollars a year, the smallest change in one assumption can lead to very large changes in the fiscal outlook—especially when carried out over a decade. Indeed, the dramatic increase in surplus projections between this past winter and this summer are the result of very small changes in economic assumptions.

But it is not just uncertainty about the economy that should give pause about these projections. Both CBO and OMB use what is called the "capped baseline." That is, they assume that total discretionary spending—including defense and emergencies—remains within the legislated caps for fiscal years 2000, 2001, and 2002.[1] After fiscal year 2002, the projections assume that discretionary spending grows only with inflation. Under this assumption, total discretionary spending over the next 10 years would be reduced by $595 billion below the fiscal year 1999 levels of nonemergency discretionary spending adjusted for inflation over the same 10-year period.[2] Although this is the only assumption that CBO and OMB appropriately can make in projections, a look at recent history makes it unlikely. It is much more likely that there will be some spending increases, and if discretionary spending exceeds these levels—either because of emergencies or because of an agreement to raise the caps—the surplus, and hence the interest savings, will be smaller. Some would also argue that projected periods of surplus would prompt a tax cut, and that, too, would shrink the surplus.

The further out the projection the more uncertain it is. Given that, it is worth noting that a little more than half the surplus projected by OMB comes in years 11-15 of the projection period. This has real significance for the policy debate: Making large long-term commitments on either the tax or spending side of the budget is very risky.

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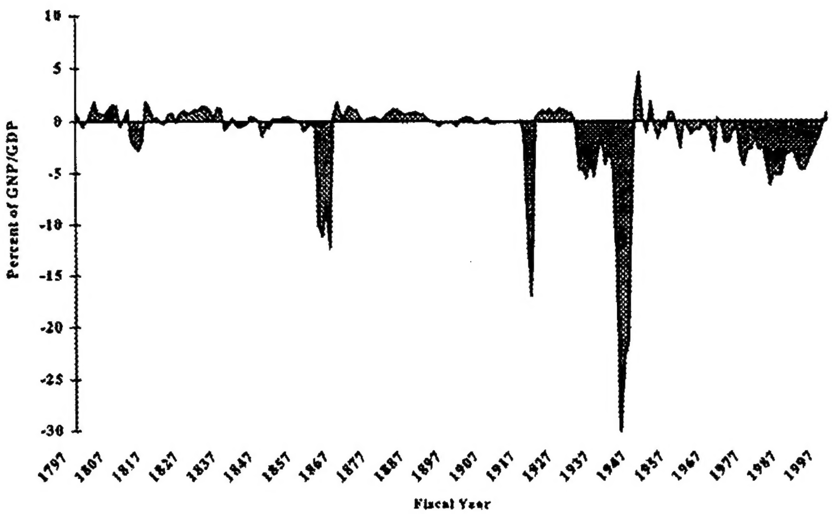
[1]OMB actually assumes that discretionary expenditures exceed the caps, but OMB also assumes offsets for those expenditures—thus the analytic point holds.
[2]This calculation is based on CBO projections.

Surpluses Follow Debt Buildup

We need to view these surpluses not in a vacuum but in the context of where we've been. Figure 1 below shows the deficit or surplus as a share of the economy since 1797.

Figure 1: Deficit/Surplus as a Share of GNP/GDP



Note: Data until 1940 are shown as a percent of gross national product (GNP); data from 1940 to present are shown as a percent of GDP.

Traditionally, in the United States, periods of high deficits and debt buildup have tracked recessions or wars and have been followed by periods of shrinking debt—usually from a combination of fiscal restraint and economic growth. According to CBO's baseline budget projections—which assume compliance with the discretionary caps—even after 2 years of budgetary surplus, debt held by the public stands at about 40 percent of GDP, a level that the United States rarely reached before 1940.

This debt is the result both of previous economic slowdowns and of the structural imbalance between spending and revenues over the last 29 years. For 29 years, the U.S. government took in less in taxes than it spent; the difference was made up by borrowing from the public.

Now we face the happy reverse—but because of the previous deficits we enter this surplus period with this overhang of debt. If the surplus were to be used entirely for spending increases or tax cuts, the budget might be in balance on an annual basis, but we would have done nothing to make up for the years of deficit spending—and we would have done nothing to remove the burden of the debt from future generations. Importantly, our demographic situation is far different now than during previous times when we emerged from prolonged periods of deficits. Longer life expectancy, the aging baby boom generation, and a relatively smaller working population means demographic

trends will be working against rather than for the financial condition of the Social Security and Medicare programs.

This debt issue is especially salient given the third reason for prudence: the looming cost pressures that face the nation and their implication for budget flexibility.

Looming Cost Pressures and Reduced Budgetary Flexibility

Nothing in either the OMB or the CBO midsession update changes the fact that our society is aging and the obligations relating to my generation, the baby boom generation, will begin coming due in the not-too-distant future. Further, increasingly people live a long time in retirement. In addition, Medicare and other health care costs historically have outpaced inflation. What I said in February remains true today, "We face a demographic tsunami in the future that poses significant challenges for the Social Security system, medicare, and our economy as a whole."[3]

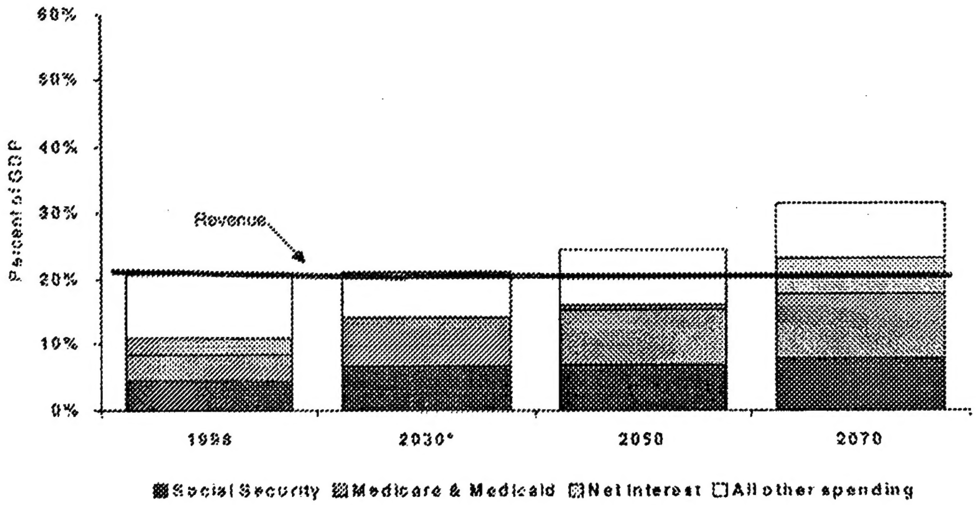
Over the next several decades the United States will experience an unprecedented shift in our demographic profile, and this shift will have consequences not only for Social Security and Medicare expenditures but also for the rest of the federal budget and economic growth. Less than 10 years from now the first baby boomers will be eligible for early retirement benefits, and—with increasing life expectancy—they will expect to live a long time in retirement. The oldest of this generation will reach early retirement age (62) in 2008, and the youngest will reach it in 2026. As the baby boom generation retires, labor force growth is expected to slow considerably and eventually stop altogether. This demographic shift is expected to cause a decline in economic growth rates as growth in total hours worked disappears. As the labor force growth stagnates, labor productivity will become even more important to economic growth. Without a major increase in productivity, low labor force growth will inevitably lead to slower growth in the economy and slower growth of federal revenues. This slower revenue growth will come at the same time that a large retired population will place major expenditure demands on federal programs for the elderly.

GAO's updated model results continue to show that even if the total surplus is saved and the budget caps adhered to, these changing demographics referred to above will—if all assumptions hold—inevitably lead to renewed deficits and growing debt, absent a change in fiscal policy. These deficits will result primarily from the combined spending pressures of Social Security, Medicare, and Medicaid. As more and more of the baby boom generation retires, these pressures will fuel new deficits—even if we save the whole surplus—and the nation will once more find itself in the vicious circle of escalating deficits, debt, and interest costs.

[3] Social Security and Surpluses: GAO's Perspective on the President's Proposals (GAO/T-AIMD/HEHS-99-95, February 23, 1999).

This longer-term problem of re-emerging deficits provides the critical backdrop for any permanent changes in tax or spending. Absent changes in current fiscal policy—and even assuming the spending caps are adhered to, and all surpluses are saved and devoted to debt reduction, spending for Social Security, health, and interest alone would absorb a little over half of all federal revenues by 2018. By 2066, this spending would consume the entire federal budget. Budgetary flexibility declines drastically, and there is increasingly little to no room for programs for national defense, the young, infrastructure, and law enforcement—i.e., essentially no discretionary programs at all. Figure 2, below, illustrates these trends.

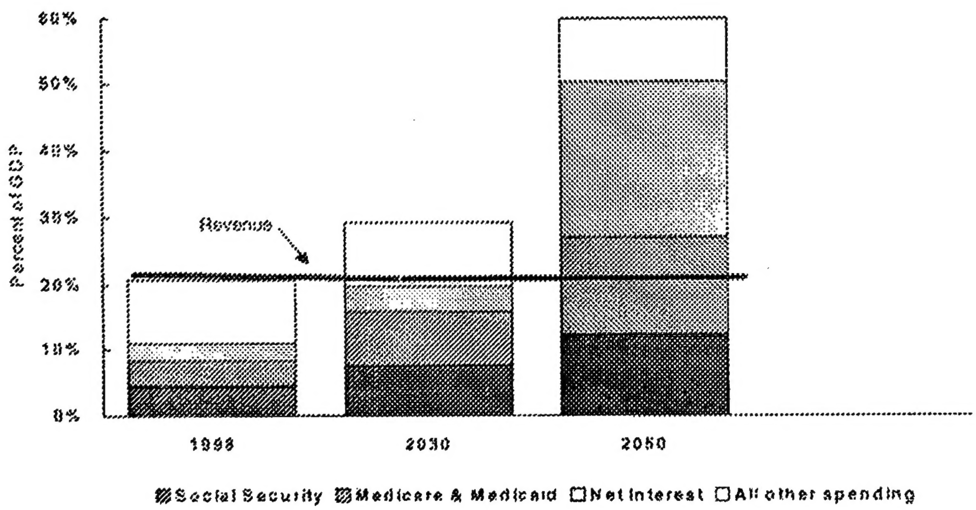
Figure 2: Composition of Spending as a Share of GDP Under "Save the Unified Surplus" Simulation



*In 2030, all other spending includes offsetting interest receipts.

Unimaginable as this picture is, as figure 3 below shows, it becomes even more dramatic if we assume the entire surplus is used—and none of it is saved. In that scenario, lower GDP and higher interest payments lead to a world in which revenues cover little beyond Social Security, health and interest payments in 2030—and by 2050 revenues don't even cover those!

Figure 3: Composition of Spending as a Share of GDP Under "No Unified Surplus" Simulation



Although views about the role of government differ, it seems unlikely that many would advocate a government devoted solely to sending checks and health care reimbursements on behalf of the elderly.

Therefore, under any fiscal and economic scenario, reforms reducing the future growth paths of Social Security, Medicare, and Medicaid are vital to restoring fiscal flexibility for taxpayers of the future. Early action yields great returns—the miracle of compounding again. Figure 4 below illustrates this for Medicare.

Figure 4: Federal Deficits as a Share of GDP Under Alternate Medicare Simulations

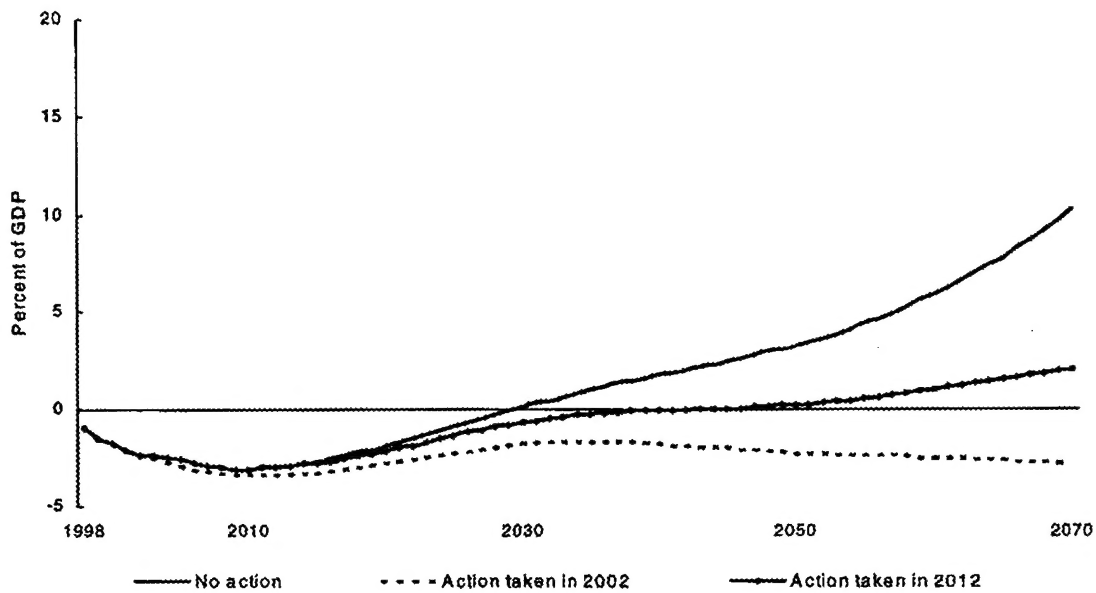


Figure 4 also shows that although reducing debt helps, debt reduction alone is not enough. Even if we were to save the entire surplus, entitlement reform would still be necessary. This is even clearer when we realize that Social Security and Medicare are not the only long-term cost pressures facing us. Federal commitments such as those for insurance, Medicaid, and environmental liabilities for the Departments of Energy and Defense cleanup will also likely result in large costs that encumber future fiscal resources and constrain future financial flexibility to meet emerging needs.

<u>Midsession Policies</u>

Overall the President proposes to reduce debt held by the public by more than he did in his February budget. He also proposes to spend more in several areas. The big items in the budget, however, remain Social Security and Medicare. There is still a need for fundamental reform of these programs to assure their long-range solvency and sustainability.

The President has changed the form of his Social Security proposal. Instead of transferring to the Social Security Trust Fund additional treasury securities equal to a

share of the unified surplus, the President proposes to use the Social Security surplus to reduce debt held by the public and then—beginning in 2011—to transfer to the Trust Fund securities equal to the "fiscal dividend"—i.e., interest savings—that results from lower publicly held debt. The Social Security Trust Fund already earns interest on its surplus. Under the new proposal it will receive, in effect, a second interest payment equal to interest savings that result from paying down publicly-held debt. This is simply a general fund transfer pegged to the interest saving. Unlike the February proposal, the general fund transfer does not start until 2011. However, this general fund transfer is open-ended in duration.

The policy in the Midsession Review envisions more debt reduction than that in the President's February budget. Under his most recent proposals, the entire Social Security surplus goes to debt reduction. The President projects that his proposals would reduce debt held by the public by $3.6 trillion over the next 15 years, virtually eliminating publicly held debt by 2015. Almost two-thirds of projected unified budget surpluses would be used to reduce the debt through lockbox provisions dedicating all of Social Security's surpluses and about a quarter of the on-budget surplus transferred to Medicare for debt reduction.

The debt reduction proposed by the President—although less than the baseline, which assumes that all surpluses would be saved—would confer significant short- and long-term benefits to the budget and the economy. GAO's work on long-term budget outlooks illustrates the benefits of maintaining surpluses for debt reduction. Interest on the debt today represents the third largest program in the federal budget. Reducing the publicly held debt reduces these costs, freeing up budgetary resources for other programmatic priorities. Under the President's plan, if all assumptions hold, interest would fall from $229 billion in 1999 to about $10 billion by 2014. For the economy, running surpluses and reducing debt increases national saving and frees up resources for private investment. This in turn leads to stronger economic growth and higher incomes over the long term.

Over the last several years, our simulations have illustrated the long-term economic consequences flowing from different fiscal policy paths. Our models consistently show that any path saving all or a major share of projected budget surpluses ultimately leads to demonstrable gains in GDP per capita over a 50-year period. GDP per capita would more than double from present levels by saving most or all of projected surpluses, while incomes in the simulation actually fall during this period if we failed to sustain any of the surplus. Although rising living standards are always important, they are especially critical for the 21st century, for they can increase the economic capacity of the projected smaller workforce to maintain a good standard of living as well as to finance future government programs and the commitments for the baby boomers' retirement.

While the President is to be commended for the amount of debt reduction, I remain concerned about the consequences for trust fund financing and reform. It is fair to note that nothing in his midsession proposal changes the fundamental structural imbalance in Social Security. The system's cash flow still turns negative in 2014 and Social Security becomes a draw on the general fund. When federal deficits re-emerge, however, baby

boomers will still be retiring with long expected lifespans in retirement. If the President's proposal to transfer interest savings to the Social Security Trust Fund is adopted, the Trust Fund solvency on paper is extended, but the structural imbalance will remain. The new securities will be redeemed and constitute a new claim on the general fund until they run out in 2053.[4] Absent substantive program reform, our children will be saddled with a budget heavily burdened by commitments to fund entitlement programs for the elderly.

At heart the President's Social Security reform proposal is a combination of debt reduction and a general fund transfer. As I have said before, I believe there are legitimate arguments on both sides of the question of bringing some general fund financing to Social Security—but the issue should be debated openly and on its merits.

Medicare is a more complicated story. Under the President's proposal some of the on-budget surplus would be transferred to Medicare, invested in federal Treasuries and so used to reduce publicly-held debt. As with Social Security, this formalizes a new claim on general fund revenues for the Hospital Insurance Trust Fund. The President also proposes to add a new benefit, namely a prescription drug benefit that is only partially funded by premiums. At the same time, the long-term cost pressures facing this program remain. Fundamental program reforms to reduce the future growth of the Medicare program are critical both to budget flexibility in the future and to any attempt to modernize and upgrade the benefit package.

The President's proposal to grant additional securities—both to Medicare and in the interest transfer to Social Security—creates the risk of reducing transparency about the underlying financial condition of these trust funds. In fact, the transfers would interfere with the vital signaling function that trust fund mechanisms can provide for policy makers about underlying fiscal imbalances in covered programs. The greatest risk is that these transfers could induce an unwarranted complacency about the financial health of these programs. From a macro perspective, the critical question is not how much a trust fund has in assets—or solvency—but whether the government as a whole has the economic capacity to finance the trust fund's claims to pay benefits now and in the future—namely, sustainability.

Concluding Observations

After some years of restraint and difficult policy choices, the goal of budget balance has been achieved. Now the Congress and the President face a series of decisions that will have a major impact on the economic future of the nation.

I believe the first issue is how much of the current and projected surpluses should be used for debt reduction. We come to these surpluses with a high level of debt built up from years of deficits. Devoting a significant portion of the surplus to reducing that debt would yield benefits in terms of lower interest costs and greater future economic capacity.

[4]According to a White House press release dated June 28, 1999.

Few would expect the entire projected surplus to go to debt reduction. Therefore, decisions must be made about how to use some portion of the surplus to respond to those demands that have had to be held in abeyance during the effort to reach budget balance: How should these funds be allocated for spending or tax cuts? The critical decision is how to strike a balance between today's needs and addressing tomorrow's challenges.

Finally, the surplus presents both opportunity and obligation. The new surplus projections offer an opportunity to address today's needs, but we should not forget our obligation to build for the future. Every generation is in part responsible for the world it passes on to the next. That responsibility may be especially great for us given the burden the aging of our society and declining worker-to-retiree ratios will place on society and the economy. We have a stewardship responsibility to reduce the debt burden we leave, to provide a strong foundation for future economic growth, and to ensure that our future commitments are both adequate and affordable. Common sense tells us that it is better to make the tough choices today while we have a healthy economy, sufficient resources to meet some current needs while still building for the future, and a relatively large cohort of workers. National saving pays future dividends—but we need to begin soon to permit compounding to work for us. In addition, we have an obligation to get on with meaningful reform of the Social Security and Medicare programs in order to make them both affordable and sustainable for the future. Finally, we should avoid attempts to create new unfunded promises before we have made significant progress on addressing current funding gaps.

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Contact and Acknowledgements

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